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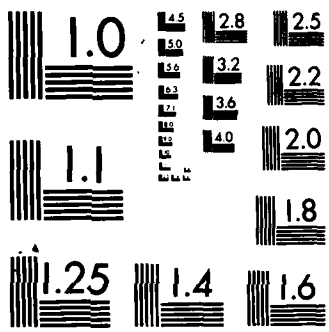
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One of the most controversial aspects of the Treasury tax reform proposal is the tax treatment of capital investment: the investment tax credit is eliminated, the write-off periods for capital goods are lengthened, and these write-offs are indexed to inflation. Numerous business groups claim that the Treasury proposal, if adopted, would reduce investment which would depress economic activity and slow growth. According to Paul Huard, vice president for tax policy at the National Association of Manufacturers, "It is inconceivable that, if implemented, this program would maintain the current level of investment." If these claims are true, the Treasury proposal may significantly harm the economy. But these claims are not true: the Treasury proposal would actually increase the incentives for most categories of capital investment when compared to present tax law.

Much of the debate on investment incentives centers on the after-tax cost of capital. When a corporation buys a capital asset, it receives two tax benefits. First, it can write off the cost of the machine over time against its income, reducing its tax payments. Second, it might receive an investment tax credit (up to 10% of the cost of the asset) which further reduces its taxes. According to our calculations, a three-year asset that sells for $100,000 costs a corporation $60,000 in after-tax dollars under current law. The Treasury proposal extends

the period over which a capital asset must be written off and tosses out the investment tax credit. The same asset would cost $71,000 in after-tax dollars under the Treasury plan. Critics of the tax reform proposal contend that this higher after-tax cost of capital will retard investment. Paul Craig Roberts has called the proposal a "scheme to deindustrialize America" which "substantially raises the cost of capital."

The concept of after-tax cost of capital, however, is seriously flawed. Corporations do not invest in capital equipment solely for the tax benefits that the investment provides. Why would a company spend a dollar on a piece of equipment if it only received forty cents in tax benefits and nothing else? The company would lose sixty cents on every dollar it invests and would quickly go broke. Instead, corporations invest in capital equipment because the equipment is productive and increases their revenue. The Treasury proposal might increase the after-tax cost of capital, but, at the same time, it reduces corporate tax rates from a maximum of 46% to 33% letting a corporation keep more of the additional revenue that the capital produces. Looking only at the cost of capital misses at least half the story: the higher after-tax cost of capital must be balanced against the higher after-tax revenue from capital.

A more appropriate concept than the after-tax cost of capital is the before-tax revenue required to justify an investment project. Building on the previous example, a three-year asset that is purchased for $100,000 might have a $60,000 after-tax cost under current tax laws. With a 46% tax rate, the investment must produce $110,000 in revenues before it is profitable. Under the Treasury plan, the same investment

might cost $70,000 after taxes, but only $107,000 in revenues are needed at the 33% rate before the project is profitable. If the project was expected to produce $108,000 in revenues, it would go forward under the Treasury proposal but not under the current tax law. In this example, the Treasury proposal would lead to higher levels of investment.

How do required revenues for other classes of assets compare under current law and the Treasury plan? Calculating required revenues is not a straightforward task. The Treasury plan indexes write-offs for inflation while current law does not. The relative attractiveness of the two methods thus depends on the inflation rate. Under both plans, investments made now lead to deductible write-offs sometime in the future. These write-offs must be discounted to their present value, and we use a 5% real discount rate in these examples.

These complications are best overcome by concrete examples. The three-year asset described above will become Class 1 property under the Treasury proposal (see Table). If the inflation rate is 5%, an asset must generate $110,000 in pre-tax revenues under current law before it is profitable. Under the Treasury proposal, only $106,000 would be needed. In fact, for any inflation rate over 2.5%, the Treasury proposal is more advantageous than the current law for this group of assets.

What about other asset groups? There are seven classes of assets under the Treasury proposal. At a 5% rate of inflation, those assets in classes 1, 2, 3, part of class 6, and class 7 would receive more favorable treatment under the Treasury proposal. These classes represent approximately 60% of current investment. If the inflation rate is 7%, the Treasury proposal is superior to current law for all assets except

those in class 5. Even class 5 assets, highly favored under the current tax code, would receive better tax treatment under the Treasury proposal at a 9% inflation rate.

Aside from those investment incentives discussed above, the Treasury plan will encourage investment in other ways that are harder to quantify. Under current law, a corporation investing in capital equipment is taking a gamble on the inflation rate. If inflation is low, the tax write-offs from the investment might cover a significant share of the purchase price of the investment. If inflation is high, the tax write-offs may be worth very little. Because the Treasury plan indexes the write-offs to inflation, investment becomes less risky to corporations. The Treasury plan also allows corporations to deduct half the cost of dividends paid to shareholders thus reducing the cost of funds that can be used for investment. Finally, the Treasury plan indexes capital gains so an individual is taxed on the real return his investments provide but not taxed on the price increases that artificially inflate the price of financial assets. This provision should further reduce the cost of investment funds.

Since for most plausible inflation rates, the Treasury proposal is so favorable to investment, it is curious that many business interests are opposing the proposal on the grounds that it will reduce investment. Three explanations come to mind. First, and charitably, these business interests might simply be mistaken about the overall tax consequences of the plan. Second, these businesses might be so short-sighted and place such a high premium on short-run profits that they prefer the quicker write-offs under current law over the ultimately higher benefits under the Treasury proposal. Third, these business interests actually

understand and possibly prefer the investment incentives under the Treasury proposal. These corporations, however, benefit greatly from other special preferences and loopholes in the current tax code, many of which would be eliminated under the Treasury plan. For example, oil companies can expense exploration and development costs under current law but not under the Treasury proposal. Also, coal producers have some of their revenue taxed preferentially at capital gains rates under the current law. The current tax code is rife with these preferences that work greatly to the advantage of certain companies or industries. Explicitly lobbying for some of these tax provisions would appear greedy and selfish. Instead, these corporations may be trying to kill the entire tax package by falsely claiming that it will reduce investment.

Table Investment Incentives

CURRENT LAW AND TREASURY PLAN

Asset Category		Required Return at 5% Inflation ($100,000 Investment)		Lowest Inflation Rate at which Proposal is Superior to Current Law
Proposal	Current Law	Proposal	Current Law	
Class 1	3 Year Property	$106,000	$110,000	2.5%
Class 2	5 Year Property	$108,000	$110,000	4.0
Class 3	5 Year Property	$110,000	$110,000	5.0
Class 4	5 Year Property	$114,000	$110,000	7.0
Class 5	5 Year Property	$118,000	$110,000	9.0
Class 6	10 Year Property	$124,000	$120,000	7.0
Class 6	15 Year Public Utility Property	$124,000	$125,000	5.0
Class 7	15 Year Low Income Housing Property	$131,000	$137,000	2.5%
Class 7	18 Year Property	$131,000	$143,000	1.0%

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